



STATE BOARD OF EQUALIZATION STAFF LEGISLATIVE BILL ANALYSIS

Date Introduced:	4/24/03	Bill No:	ACA 16
Tax:	Property	Author:	Hancock
Board Position:		Related Bills:	SB 17 (2003) SB 3X (2003) SB 1662 (2002) AB 1013 (2001) AB 2288 (2000) SB 82 (1991) Proposition 167 (1992)

BILL SUMMARY

This bill would place a constitutional amendment before voters to require annual reassessment of nonresidential, nonagricultural property to current fair market value.

ANALYSIS

Current Law

Under existing property tax law, real property subject to taxation by the county assessor is reassessed to its current fair market value only when there is a "change in ownership" or new construction. (*Article XIII A, Sec. 2; Revenue and Taxation Code Sections 60 - 69.5 and 70 - 74.6*)

Proposed Law

If enacted and approved by voters, this bill would add Section 2.5 to Article XIII A of the California Constitution to provide that beginning on January 1, 2005 and each January 1 thereafter (i.e., the "lien date") the "full cash value" of nonresidential real property, not used for permanent or long-term commercial agricultural production as defined in statute, is the fair market value of that property as of that date.

In General

Property Tax System. Proposition 13 approved by voters in 1978 changed the standard of value upon which property taxes would be based from a current market value standard (in practice property was reassessed periodically, usually in a three or five year cycle, to its current market value) to a value based on current market value at the time property is acquired (or for property that was acquired prior to 1978 the current market value of the property in 1975).

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In general, California's system of property taxation under Article XIII A of the State Constitution (Proposition 13) values property at its 1975 fair market value, with annual increases limited to the inflation rate, as measured by the California Consumer Price Index, or 2%, whichever is less, until the property changes ownership. At the time of the ownership change, the value of the property for property tax purposes is redetermined based on current market value. The value initially established, or redetermined where appropriate, is referred to as the "base year value." Thereafter, the base year value is subject to annual increases for inflation. This value is referred to as the "factored base year value."

Change in Ownership. While Proposition 13 provided that a "change in ownership" would trigger reassessment, the phrase was not defined. The Assembly Revenue and Taxation Committee appointed a special Task Force - a broad based 35-member panel that included legislative and Board staff, county assessors, attorneys in the public and private sectors, and trade associations - to recommend the statutory implementation for Proposition 13 including its change in ownership provisions. The Task Force findings are published in California State Assembly Publication 723, **Report of the Task Force on Property Tax Administration**, January 22, 1979. A second report, **Implementation of Proposition 13, Volume 1, Property Tax Assessment**, prepared by the Assembly Revenue and Taxation Committee, California State Assembly Publication 748, October 29, 1979, provides additional information on how changes in ownership would be determined under Proposition 13.

Task Force Choices for Property Owned by Legal Entities. One issue the Task Force faced was how to apply the change in ownership provisions of Proposition 13 to property owned by a legal entity. For instance, would a transfer of ownership interests in a legal entity that owns real property be considered a transfer of the real property interests and, thus, a change in ownership? The Task Force considered two alternatives, that were coined the "separate entity" theory and the "ultimate control" theory.

- **Separate Entity Theory.** The "separate identity" theory would respect the separate identity of the legal entity. Accordingly, for as long as the legal entity owned the property it would not be reassessed, even if all of the ownership interests in the legal entity had transferred.
- **Ultimate Control Theory.** The "ultimate control" theory would look through the legal entity to determine who held the ownership interests and, thus, who had "ultimate control" of the legal entity. Under this theory, real property owned by the legal entity would be reassessed only when a single holder of ownership interests gained control of the legal entity through the acquisition of a majority of those ownership interests.

The Task Force recommended that the separate entity theory be adopted for the following two reasons:

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"(a) The administrative and enforcement problems of the ultimate control approach are monumental. How is the assessor to learn when ultimate control of a corporation or partnership has changed? Moreover, when the rules are spelled out (and the Task Force actually drafted ultimate control statutes) it became apparent that without trying to cheat, many taxpayers as well as assessors would simply not know that a change in ownership occurred. The separate entity approach is vastly simpler for taxpayers and assessors to understand, apply and enforce. Transfers between individuals and entities, or among entities, will generally be recorded. Even if unrecorded the real property will have to be transferred (by unrecorded deed or contract of sale, for example). Taxpayers can justifiably be expected to understand that a transfer of real property is a change in ownership and must be reported to the assessor.

(b) The ripple effects of ignoring the general separate entity laws of the state could not be predicted. The ultimate control theory threatened unknown disruptions of business organizations and practices. The separate entity approach avoids that pitfall by adopting the existing structure of corporate, partnership, etc. laws and building upon them."

Property Owned by Legal Entities - The Law Today. The change in ownership definitions related to ownership interests in legal entities initially codified in 1979 was based on the "separate entity theory" as recommended by the Task Force. However, thereafter, subdivision (c) of Section 64 was added to provide that a change in ownership occurs whenever there is a **change in control** by a transfer (or transfers) of more than 50% of the total ownership interests to a single person or entity.

According to **Implementation of Proposition 13**, Assembly Publication 748, subdivision (c), coined "the majority-takeover-of-corporate stock" provision was added "out of a concern that, given the lower turnover rate of corporate property, mergers or other transfer of majority controlling ownership should result in a reappraisal of the corporation's property -- an effort to maintain some parity with the increasing relative tax burden of residential property statewide, due to more rapid turnover of homes. It was also a trade-off for exempting certain transfers among 100% wholly-owned corporations."¹

Currently, there are separate definitions of change in ownership for "transfers of interests **in real property**" and "transfers of ownership interests **in legal entities**" that own real property. Under the existing definitions of change in ownership, it is possible that the ownership interests in a legal entity may undergo a complete turnover in a series of transactions, but that the real property owned by the legal entity will not be reassessed. Generally, when individuals transfer interests in real property a proportional change in ownership occurs. For example:

¹ Section 64(b) excludes transfers of ownership interests between affiliated corporations and Section 62(a)(2) excludes transfers which result in change in the method of holding title while the proportional ownership interests remain unchanged.

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- **Individual Ownership:** Four individuals each own a 25% interest in a property. Each time an individual sells their interest to another person, a 25% reassessment of the property is triggered.
- **Legal Entity Ownership:** If the same property is owned by a legal entity in which the same four individuals each own a 25% interest in the legal entity, then if an individual sells their 25% interest in the legal entity to someone else, no reassessment will occur. This is true even if each of the four individuals sell their interests to other persons. Only if one person or entity obtains control (more than 50%) will a change in ownership be triggered.

Tax Burden The Task Force expressed concern that because commercial and industrial property changes ownership less frequently than residential property, a shift in tax burden to residential taxpayers could occur. The definitions originally proposed for legal entities (based on the separate entity theory) were chosen to mitigate administrative difficulties. Because of this concern, the Task Force proposed that the Legislature study the idea of a constitutional amendment to periodically appraise commercial and industrial property noting:

"[s]uch a constitutional change would also result in far greater simplicity in the treatment of legal entities. If commercial and industrial properties were to be periodically reappraised for reasons other than change in ownership, the difficult and controversial policy issues in choosing between the "ultimate control" approach or "separate entity" approach, outlined previously, would largely be avoided. The Task Force commends the principle of such a change to the Legislature for additional study."

Homeowners' Percentage of Total Value. The following information, which is annually prepared by the Board's Research and Statistics Section, lists the percentage of gross assessed value from properties receiving the homeowners' exemption compared to total assessed value.

1979-80	33.6%	1987-88	32.5%	1995-1996	37.6%
1980-81	36.3%	1988-89	32.6%	1996-1997	38.0%
1981-82	35.4%	1989-90	33.1%	1997-1998	37.9%
1982-83	34.5%	1990-91	32.8%	1998-1999	38.1%
1983-84	33.6%	1991-92	33.0%	1999-2000	38.2%
1984-85	32.9%	1992-93	34.2%	2000-2001	38.1%
1985-86	32.5%	1993-94	35.3%	2001-2002	38.0%
1986-87	32.4%	1994-95	36.7%		

Background

Other bills that would have resulted in more frequent reassessment of property owned by legal entities include SB 1662 (Peace) in 2002, AB 1013 (Leonard) in 2001, AB 2288 (Dutra) in 2000, and SB 82 (Kopp, et al) in 1991. Additionally, Proposition 167 in 1992, which addressed a number of tax related items, included a provision to modify

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the change in ownership definitions related to legal entities. Proposition 167 was not approved by voters (41.16% - 58.84%).

COMMENTS

1. **Sponsor and purpose.** This bill is sponsored by the author. Its purpose is to require that property taxes paid on nonresidential property be based upon the current market value of that property.
2. **What is a "split roll"?** This legislation is referred to as creating a "split roll." Typically when the phrase "split roll" is used, it means taxing certain types of property according to a different standard of value or at a different tax rate. But the phrase has also been used to refer to legislation that statutorily modifies the change in ownership definitions for legal entities. A **true** "split roll" is only possible with a constitutional amendment, such as this bill proposes.
3. **Property subject to this bill would be reassessed at current fair market value each year, while all other property would be essentially assessed at its acquisition value with an annual inflation adjustment.** The constitution requires that all property (unless specifically provided for elsewhere in the constitution) be assessed at the same percentage of "fair market value." To assess a specific class or type of property (i.e., residential, agricultural, commercial, industrial, or bare land) at a different standard of value requires a constitutional amendment, such as this bill proposes. (Article XIII, Section 1)
4. **The original 1978-79 Proposition 13 Task Force proposed that the Legislature study a constitutional change to periodically reappraise commercial and industrial property.** The Proposition 13 Task Force considered and debated the issue of transfers of interests in legal entities. The Task Force recognized the effect of these definitions over the long term noting "(t)he Task Force admits that some of its own recommendations, such as those regarding legal entities, while the best of a seemingly 'no-win' choice of options and adopted to mitigate administrative difficulties, may, in the long run, further exacerbate this [tax burden] shift to residential property because it will result in fewer potential commercial and industrial property transfers being recognized for reappraisal purposes." Consequently, the Task Force proposed that the Legislature later study a constitutional change to periodically reappraise commercial and industrial property.
5. **Property owned by a legal entity since 1978 may never be reassessed to current market values.** It is possible that real property owned by a legal entity since 1978 has never undergone a change in ownership and will never be reassessed, as long as the current definitions hold.
6. **Property taxes paid by legal entities generally increase over time.** Businesses, unlike homeowners, also pay property taxes on their personal property holdings. Their personal property is assessed every year at its current market value.

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Additionally, as businesses grow and expand, any real property that a legal entity newly constructs or acquires is reassessed to current market value. Further, mergers and takeovers of corporations can result in reassessment triggers.

7. **Proponents of a move for a "split roll" note that the current system is inequitable and that the tax burden is shifting to homeowners.** Individuals are not able to shield incremental transfers of interests from reassessment like property that is owned by a legal entity. With respect to shifting tax burdens, the share of assessed value from owner occupied homes increased from 33.6% in 1979 to 38.0% in 2001. The percentage change from year to year varies and in some years has declined.
8. **The Legislative Analyst's Office addressed the disparity in the frequency of reassessment of property owned by individuals versus legal entities.** In a report issued to the Legislature by the Legislative Analyst's Office in 2001, "Reconsidering AB 8: Exploring Alternative Ways to Allocate Property Taxes," related to the frequency of reassessments for residential versus commercial and industrial property, the report noted,

"For residential property, this acquisition value-based system has some policy merit. Specifically, it (1) encourages stable communities and (2) ensures no sharp increases in taxes from year to year (of particular concern for senior citizen homeowners on fixed incomes). At the same time, however, new homeowners – both first time homebuyers and those relocating - bear a disproportionate share of the residential property tax burden. It is only after a number of years of homeownership that the financial benefits of the acquisition assessment system accrue to homeowners.

The same benefits of the acquisition value system exist in terms of commercial and industrial property; however, the disadvantages of this policy for businesses in a competitive economy are somewhat troubling. The system can present an economic barrier to entry for new businesses. If a competitor has been in the same location for a number of years, a new business faces higher operating costs. This can discourage the formation of new businesses and reduce competition."

9. **Certain "nonresidential" properties eligible for special assessment procedures provided for in Article XIII of the California Constitution would not be affected by this bill. Those include:**
 - **Open Space Land (Williamson Act).** Enforceably restricted open space land to recreation, enjoyment of scenic beauty, use or conservation of natural resources, or production of food or fiber. (*Art. XIII, Sec. 8*)
 - **Historical Property.** Enforceably restricted property of historical significance. (*Art. XIII, Sec. 8*)

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- **Certain Golf Courses.** Nonprofit golf courses of 10 acres or more. (*Art. XIII, Sec. 10*)
- **Taxable Government Owned Property.** Taxable property owned by a local government that is located outside its boundaries. (*Art. XIII, Sec. 11*)
- **Timberland Production Zones.** Contractually restricted property for growing and harvesting timber. (*Art. XIII, Sec. 3(j)*)

10. **State Assessed Property is assessed at annual fair market values.** The value standard for any property assessed by the Board of Equalization is annual current market value. This generally includes property owned or used by telephone carriers, telephone carriers, wireless carriers, radio-telephone carriers, gas, electric, and water companies, pipeline companies, railroad companies, railroad maintenance and private railroad cars.

11. **Opponents of a "split roll" note that ultimately the higher property taxes paid by legal entities that own California real estate would result in:**

- higher cost of goods and services
- increase in rents for leased real property
- loss of business growth to other states and countries
- reduction of California competitiveness
- decrease in profits to owners and investors including retirees
- lower wages for employees of legal entities
- increase in size of government
- increase in government employee salaries

Additionally, opponents note that current market value based assessments shift property tax values from an objective to a subjective standard of value (i.e., sales price vs. assessors opinion of value).

12. **The Administrative Workload.** Commercial and industrial properties are the most complex type of property to appraise and county assessors' offices would likely need to hire more real estate appraisers to handle the increase in annual real estate appraisal workload that this bill would create. Additional resources would be necessary to (1) identify nonresidential property affected, (2) appraise the properties annually, (3) defend or modify the appraisal pursuant to a formal or informal appeals, and (4) defend reassessments in court actions.

13. **Counties are not fully reimbursed for their administrative costs.** Counties perform the administrative duties of the property tax on behalf of all local governments and schools. But schools, which receive 52% of the property tax revenues, are not required to pay a pro-rata share of the administration costs, unlike other local governments. Counties receive only 19% of the property tax revenue. In recognition of this, the state has enacted the State-County Property Tax Administration Program which makes available \$60 million per year for counties.

The Legislative Analyst in a 1997 Report, **Improving the Incentives for Property Tax Administration**, notes:

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“The state has a significant interest in the property tax. Although the property tax has been considered a local tax, the state is in fact the largest beneficiary of property tax revenue growth. This is because increases in property tax revenues generally result in commensurate decreases in the required state contribution for education.

In spite of the considerable state interest in the property tax, the costs of property tax administration are borne almost entirely by local governments. Specifically, counties receive less than 20 percent of property taxes collected, yet they pay more than 70 percent of property tax administration costs. As a result, counties face a disincentive to investing in the property tax administration system. www.lao.ca.gov”

14. Implementation Considerations:

- **Defining Nonresidential Properties.** The motivation for property owners and the pressure on tax administrators to classify property as "residential" rather than "nonresidential" could be significant given the potential tax implications. Types of properties where the residential v. nonresidential classification may cause some difficulties, include:
 - Hotels (some hotels sell individual units as condominiums or time shares)
 - Motels (some motels are long term rentals)
 - Bed and Breakfast (owner-occupied)
 - Campgrounds
 - Timeshares
 - Assisted living facilities or convalescent homes
- **Mixed Use Properties.** There are parcels of land with residential and non-residential portions, either in separate or combined structures. In addition, there are properties that have a mixture of residential and non-residential within the same structure, such as live-work spaces and lofts.
- **Defining "Commercial Agricultural Production."** The motivation for property owners and the pressure on tax administrators to classify property as "used for permanent or long-term commercial agricultural production" could be significant given the potential tax implications. As currently drafted, the definitions would be initially defined by statute and, thereafter, could be modified by the Legislature to expand or contract the meaning of the phrase. Additionally, the Board could promulgate regulations to further define those terms. Any property types that this bill is definitely intended to include or exclude could be amended into the constitution to ensure that the author's intent is preserved. The phrase "used for permanent or long-term commercial agricultural production" could be extended beyond the cultivation of land or the growing, raising, or gathering of commodities and the raising of livestock, if that is the author's intent. For example, real property used in food processing, timber processing, and/or winemaking operations could be argued to be a commercial agricultural production. Each of the words used in the definition could be subject to some element of question in practical application:

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- "Used"
- "Permanent or long term"
- "Commercial"
- "Agricultural"
- "Production"

COST ESTIMATE

With respect to property taxes, the Board would incur some minor absorbable costs in informing and advising local county assessors, the public, and staff of the law changes.

REVENUE ESTIMATE

The following table shows the estimated distribution of assessed value on the 2002-03 roll by property type. Values include the homeowners' exemption but exclude all other exemptions.

Locally Assessed Real Property By Property Type	Assessed Value In Billions
Single Family Residential	\$1,504.9
Vacant Residential Land	38.4
Multiple Family Residential	238.4
Rural and Timber	75.3
Commercial/Industrial	675.0
Other	14.6
Total	\$2,546.6

The property type "Other" contains properties that do not clearly lend themselves to categorization. Examples of properties that might be included are water rights, publicly owned properties, timeshares, and vacant land the use of which is unidentified.

This bill would provide that the assessed value of nonresidential, non-agricultural real property would be full market value rather than the current Proposition 13 restricted value. The current assessed value of these properties is:

Property Type	Assessed Value In Billions
Commercial/Industrial	\$675.0
Other	14.6
Total	\$689.6

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The Board does a study each year to determine the effective assessment level for commercial/industrial property in order to determine the assessment level for rail transportation property. The latest study, completed in May 2003 was based on information from the 2001-02 assessment roll. That study found that the effective assessment level for locally assessed real commercial/industrial property was 70.56%. If we apply this ratio to the assessed value estimated above, we calculate the market value of this property to be \$977.3 billion, an increase of \$287.7 billion. The property tax revenue at the basic 1% tax rate on this increase in value would be \$2.9 billion.

Revenue Summary

The revenue impact from specifying that the “full cash value” of nonresidential, non-agricultural real property is the fair market value would be a revenue increase of \$2.9 billion annually.

Analysis prepared by:	Rose Marie Kinnee	916-445-6777	06/09/03
Revenue estimate by:	Dave Hayes	916-445-0840	
Contact:	Margaret S. Shedd	916-322-2376	

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